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There is a general belief that recent management of the U.S. economy has been brilliant. Its long period of economic growth is generally assumed to cast great credit on the Federal Reserve. But there is an alternative view that the recent management of the economy has in fact been abysmal and therefore provides a very worrying precedent for the future… An important part of the answer is the evidence of history, which suggests that allowing asset bubbles to develop is the greatest mistake that a central bank can make.

— Andrew Smithers and Stephen Wright, *Valuing Wall Street*, 2000

THE GREAT WEALTH DELUSION

You hear and read it all around you. Massive monetary and fiscal stimulus in the United States is, after all, paying off. The economy is finally on the road to a self-sustaining recovery. Among all the good news, the most appreciated is certainly about exploding profits. If true, it would go a long way to support the current high stock valuations; and even more importantly, it would be the best stimulus for the return of higher business investment spending. Could the U.S. economy's profit carnage that started in 1997 be over?

What we see, for our part, scrutinizing the numbers, definitely does not have the slightest similarity with the self-sustaining recoveries of the past, neither in their pattern nor in their impetus. When the stock bubble burst in 2000, the Fed alleviated its negative economic impact with the rapid massacre of short-term interest rates and repeated public promises to keep them at their rock-bottom lows.

America's powerful leveraged speculating community heard and responded promptly with a frenzied stampede into the highly leveraged carry trade of long-term bonds. Promptly plummeting long-term rates promptly slashed mortgage rates, which just as promptly unleashed and propelled the unprecedented mortgage refinancing orgy. Equity extraction from owner-occupied homes has been running at an annual rate of around $600–700 billion both in 2002 and 2003.

In hindsight, it is manifest that this huge equity extraction from homes has been the main source of all movements in the U.S. economy and its financial markets over the past two years. The extracted money went into the purchases of houses and stocks, driving up their prices, which provided the sharply higher collateral values for more and more consumer borrowing and spending.

Pondering the U.S. economy's further development in 2004, one question is uppermost for us: What is going to happen to this main source of its growth in 2003? Will this home equity-extraction bubble continue or not? In our opinion, it may not burst; but it is sure to slow sharply.

We wonder, actually, whether the U.S. economy's recovery has already peaked. After three years of unprecedented consumer borrowing and spending excesses, we see little scope for more of the same. American financial institutions have been literally printing money, but they print it exclusively for consumption and financial speculation. As to the power of aggressive monetary and fiscal policy ease, they have been largely spent.

The lowest interest rates in half a century have definitely failed to generate a self-sustained, strong economic recovery. The only identifiable result so far has been the creation of an array of bubbles in various assets — stocks, bonds, housing — all of them fueling higher consumer spending.

There is now a growing realization that the generally hoped for, sustained strong economic recovery in the United States will require a major boost from sharply accelerating capital investment and large-scale hiring.

For the bullish consensus, it is beyond any question that the U.S. investment recovery definitely started in the third quarter of last year, to be followed now by stronger business hiring that, in turn, will create the still lacking strong growth of wage and salary incomes.

According to various sentiment surveys, bullishness of investors in the United States is at record levels. Not surprisingly, it perfectly juxtaposes with the rampant optimism of the great majority of economists about the economy's growth prospects. Pondering the particular sources of this optimism, we have come to the conclusion that it is really nothing but the very same old optimism and overconfidence that prevailed during the past boom years.

CHRONIC AMERICAN OPTIMISM

The contrast in consumer behavior between America and Europe could not be more striking. Across most of the eurozone, the development of retail sales in the past few months has been an outright disaster, even though incomes in Europe have performed slightly better than in America.

Retail sales volume in the United States last November was more than 6% above its level a year ago. In Germany, France, the Netherlands, Belgium and Austria such sales were between 2–6% below their year-over-year level. Worrying about their jobs, the Europeans have increased their saving, while their American counterparts have been stampeding into an unprecedented borrowing binge.

We think it is reasonable to interpret changes in the savings rate as indicators of changes in confidence. Radically opposite savings behaviors of households in the United States and in the eurozone suggest radically different expectations on their part about economic prospects. The borrowing and spending binge of the American consumer, as a matter of fact, makes the crucial difference between the economic performances on the two continents.

This raises two correlated questions: *first*, the possible causes of this tremendous difference in consumer behavior; and *second*, the sustainability of the consumer borrowing and spending binge in the United States.

There can be no question that the American public is far more optimistic about economic prospects than the European public. Yet there is far more at play than just differences in mood and expectations.

As to Europe, borrowing for consumption still has a bad taste, both among people and banks. Credit cards are strictly for payment convenience, not for credit. High levels of outstanding consumer credit are overwhelmingly related to existing high price levels of housing. To raise an existing mortgage is virtually impossible. Neither owners nor bankers think of increasing house prices as wealth creation justifying a higher mortgage. House price statistics find zero attention. Banks that actively promote consumer lending are a rare exception in Europe; the biggest one is Citibank. Even they, though, avoid publicity about it.

Surveying the U.S. economy's performance over the last three to four years, we see ever-mounting structural imbalances: the worst job performance in the world, a rock-bottom national savings rate, a record current account and trade gap; a huge and soaring budget deficit; record levels of personal indebtedness; the most unbridled credit expansion in history; and a plunging currency. Without the huge interventions by Japan's and China's central banks, the dollar would collapse with disastrous consequences for the U.S. financial markets. So why are American economists and the general public so optimistic?

It probably has a variety of reasons. First the most striking to us is the drastic difference in efforts to influence public opinion in a bullish way. For years there has been an orchestrated campaign of economic cheerleading by policymakers, Wall Street and the media in the United States. The top cheerleader is, of course, Fed Chief Alan Greenspan. There is no such cheerleading in Europe. None is expected, least of all, by the way, from the head of the European Central Bank.

Second, today there is a tremendous discrepancy between economists in Europe and America in their approach

and whole pattern of thinking about the necessities of economic growth. Economists on both sides of the Atlantic spoke the same language and worried about the same problems: savings, capital investment, profits, the balance of payments and structural imbalances. Consider that leading "Austrians," Gottfried Haberler, Fritz Machlup, and William Fellner, with whom we had personal contact, played a key role in the public discussion.

AMERICA'S CENTRAL IMBALANCE: OVERCONSUMPTION

As to the latter, today's American economists are at a complete loss about the meaning of "structural imbalances." Raymond J. Saulnier, economic advisor to President Dwight Eisenhower, emphasized in a paper published in 1975 that ***"expansionary policies designed to promote recovery or to accelerate growth are often carried to excess and result not only in an outbreak of inflation but in structural imbalances that sooner or later make recession a virtual certainty."***

Clearly, Saulnier worried more about the latter as a cause of recession. In fact, rising inflation rates as such never drive an economy into recession, but the monetary tightening by the central bank that it triggers over time. That is the key difference to structural imbalances. They slam economic growth directly. The U.S. economy in the past few years has accumulated a whole variety of major growth-imparing structural imbalances, but the Fed and most American economists refuse to see any causal relation to the economy's subpar performance. Yet, to repeat Saulnier, they *"sooner or later make recession a virtual certainty."*

But what exactly are structural imbalances? In short, they mean major, unsustainable spending excesses by businesses or consumers. Such imbalances occur in every cyclical upturn, as certain demand components rise faster than the average. What gives them the structural touch is their size and duration.

America's most conspicuous structural imbalance that has accumulated during the bubble years since mid-1990 is plainly in a consumer borrowing and spending binge. A prolonged, sharp rise of personal consumption as a share of GDP from 63% to 70% and the savings collapse have been the striking hallmarks of this development.

But such a steep rise of one demand component in GDP does not take place in a vacuum. Implicitly, it requires that additional resources have to be extracted from other GDP components. In the U.S. case, these additional resources came largely through the trade balance from soaring imports of goods.

Over time, though, the developing overconsumption also strangled business investment spending through changes in relative prices. If the demand for consumer goods rises relative to the demand for capital goods, the consumer sector becomes more profitable. And labor and capital are enticed away from the capital goods sector.

Putting it into an expression that is familiar in connection with budget deficits, higher consumption crowds out investment. Whether government dissaving or consumer dissaving, both have the same evil effect of crowding out investment or foreign trade.

Stating this, it strikes us that more and more people are lamenting President Bush's soaring budget deficits, but we have yet to read that somebody laments the harmful effects of the consumer borrowing and spending excesses for U.S. economic growth in the longer run. Actually, protracted excess consumption (in relation to income) is the U.S. economy's most dangerous structural imbalance.

The fact is that the traditional American model of economic growth assigns a leading role to changes in consumer spending. Implying that businesses increase their investments only when they see higher demand, it is assumed that this higher demand must essentially come from consumer spending, being by far the biggest component of GDP.

CONSUMPTION VS. INVESTMENT — WHAT LEADS WHAT?

It is further assumed that rising consumer demand stimulates capital investment. This relationship used to be well known as the "acceleration principle," in contrast to the "multiplier principle," which postulates the exact opposite —

that increasing investment spending leads to higher consumer spending.

It is, of course, an all-important question for economic policy: What leads the business cycle — consumption or investment? And even more importantly: What creates economic growth and prosperity in the long run?

In this question, there has always been a great divide between the economists in America and in continental Europe. For American policymakers and the great majority of economists, it is virtual doctrine that strong consumer spending is the key condition for full employment. It is the general assumption that capital investment will then take care of itself. In line with this pattern of thinking, policies of all American presidents during the postwar period were primarily aimed at stimulating consumption, and just as typically, this has always found general acclaim.

Europe's great economic thinkers of the past hypothesized the diametrically opposite view. Their views differed in details, but the general message was that the ups and downs of the business cycle are determined by the laws of saving and investment, not by the laws of consumption. The true limit to investment and production is capital or available saving, not consumption. The decisive, dynamic elements for healthy economic growth, according to the dominant business cycle theory in Europe, is investment, with consumption passively responding as incomes rise and fall. Their key point was that capital investment directly increases consumer incomes by the associated employment in the capital foods industries.

This new way of thinking about the business cycle emerged in continental Europe during 1898–1913. Until then, it was widely held that weak economic growth had its main cause in underconsumption.

The pioneer of this radically new approach was a Russian professor, Dr. Michael Tugan-Baranovski, with a book about the *Theory and History of Trade Crises in England*, published in German in 1901.

There, Tugan-Baranovsky made revolutionary statements, such as in the capitalist economy, income-creating production governs consumption, not the other way around; the true limit to production is capital, not consumption. He also emphasized that the aim of production in the capitalist economy is not to satisfy consumer demand, but the creation of productive capital stock and the pursuit of profits by businessmen.

The discussion about the new business-cycle theory mainly took place between the leading Swedish and German economists, and in the German language. The language problem excluded the participation of English-speaking economists. Yet one of them, J. Maynard Keynes, was heavily influenced. In his *Treatise*, published in 1930, he explicitly states: *"I feel myself in sympathy with the school of writers — Tugan-Baranovski, Spiethoff and Schumpeter — of which Tugan-Baranovski was the first and the most original."*

In his book of over 400 pages, Tugan-Baranovski analyzed in astonishing detail the many crises that the British economy and its banking system experienced during the 19th century. His conclusion was that every crisis arises from the fact that during the boom and the following downturn the *"proportional distribution of the productive forces is deranged."* Equilibrium of demand and supply is shattered. In the prosperity phase, some branches expand faster than others; and during the following downturn, some industries decline faster than others. In this way, partial overinvestment turns into general overinvestment.

To repeat for emphasis, for Keynes and the continental European economists, investment is the strategic variable in the creation of economic growth and employment. Marginal profits in conjunction with the rate of interest determine the volume of new investment. This in turn determines the development of employment, given a rather stable propensity to consume and to save. In this model, consumption is unable to lead a recovery, simply because it essentially depends on income growth, which in turn depends on rising production.

With Tugan-Baranowski began a new way of thinking about the business cycle in Europe. It became the accepted idea that economic growth and prosperity depend on autonomous investment guided by relative prices and profit expectations.

We have recalled this episode in the history of economic theory from more than 100 years ago because it gives

food for thought about the present situation in the United States. America's prolonged subpar economic growth has its obvious cause in the collapse of business investment spending preceded by collapsing profits.

ANTI-SAVINGS MENTALITY

The U.S. economy has always been a low-savings and low-investment economy compared to continental Europe, Japan and now Asia as a whole. In his book *Capital in the U.S. Economy* (1961), Simon Kuznet wrote: *"This country's economy is geared to consumption, and our institutions and patterns of social behavior encourage higher consumption. It is unrealistic to assume that these well-established institutions and patterns will be radically changed in the foreseeable future."*

In his book, Kuznet ponders why the *"ultimate consumers in our rapidly growing economy managed to save only a small proportion of their income, and a proportion which, on a net basis, declined rather than rose, despite rising real income per capita."*

When he made this statement, gross capital formation in the United States accounted for 20% of GDP. This rate broadly lasted until the late 1970s. In 1979, gross savings had dived to $540.9 billion, or 20.8% of GDP. Of this total, personal savings equaled 5.1% of GDP and business savings (undistributed profits) another 2.1% of GDP. With a small contribution by the government sector, net national savings in 1979 tallied as 7.3% of GDP.

But since the early 1980s, both gross capital formation and national savings have plummeted to postwar record lows. Gross capital formation has lately been running at 13.5% of GDP, while net national savings have lately dived toward 1% of GDP.

It is, of course, an unbelievable irony that this collapse of available savings in the United States has occurred during the two decades in which the economy is supposed to have been subject to miraculous improvements in efficiency. Regarding capital formation as the key source of economic progress, this savings and investment collapse has always been one major reason for us to discard the trumpeted story of a productivity miracle as a statistical hoax.

But is this savings collapse a serious problem for the U.S. economy or not? The bullish consensus in the United States sees only one single effect, and that appears to be highly positive for the economy. That is the implicit consumer-spending boom. Welcoming this positive effect on economic growth, they cannot be bothered to think about vanished savings.

Yes, but this plainly positive effect of the aggressive monetary and fiscal stimulus administered in the past few years has had a variety of adverse effects on the economy's supply side that, on balance, strangle economic growth.

There is a general complete disregard of these side effects jointly impairing the economy's viability. Intrinsic to them all is the same underlying fact: an unsustainable, major change in the economy's pattern of growth. Emphasis is on "unsustainable." In the United States, for years the consumer has been spending a far greater part of his current income than in the past, as reflected both in his sharply lower savings and in the sharp rise of consumption as a share of GDP.

Such a drastic shift in spending calls forth many other changes in the economy. Essentially, investment and production adjust to this shift in the demand pattern. Business investment has declined and shifted, moreover, toward the booming consumer businesses. In 2003, consumer incomes grew $331 billion, or 3.7%, while consumer debts surged by close to $1 trillion, or more than 10%. This relationship is certainly unsustainable, and further keep in mind that any slowdown in the borrowing and spending binge spells serious economic and financial trouble.

Of those various deleterious effects of consumption, the single-most spectacular, and also most harmful, one is the monstrous trade gap, now exceeding $500 billion, or 5% of GDP per year. With this amount, as we have repeatedly explained and stressed in past letters, the trade gap is America's voracious, internal income and profit killer. How does that work?

Outlays for imported goods may come either from current income or from credit. Wage and salary disbursements, by far the biggest income component, essentially accrue from business expenses. In general, such income paid to domestic workers returns through their spending (less personal saving) to the business sector as revenue, covering the earlier expenses. Credit-financed spending, on the other hand, increases the business sector's profits.

Now the harmful point about a trade gap is that it disrupts this circular flow from business expense to business revenue. An equal amount of domestic spending is diverted from domestic producers to foreign producers, involving a corresponding loss of revenue for the former and an equal gain of revenue for the latter.

A loss of revenue from domestic spending to the tune of more than $500 billion per year for sure badly hurts American businesses, but there is an aggravating factor that spells disaster for profits: A large part of the money leaking into soaring imports comes, of course, from earned current incomes, and these inherently come from current expenses of American businesses. To that extent, the soaring trade gap has played a key role in the U.S. profit squeeze since 1997.

American policymakers and economists like to comfort themselves and the public with the idea that such deficits typically distinguish strong-growth economies. In reality, they are typical of economies with consumption-driven economic growth. Economies with high investment and savings ratios inexorably run a trade surplus.

In hindsight, 1997 turns out to have been the watershed year for the U.S. economy, but in drastic contrast to what the New Economy propaganda was trumpeting. Far from surging to the moon, as generally predicted and expected, corporate profits hit a wall while the economy boomed.

Three years later, in 2000, at the height of the boom, nonfinancial profits of $423 billion were 16% below their level in 1997 ($504 billion). Measured against the rising GDP, this represented a pretty steep decline.

THINK MACRO, NOT MICRO

How could this be? A booming economy usually brings booming profits, and this particular boom was euphorically hailed to be producing a productivity miracle, inexorably leading to a profit miracle. The big question, is, of course, what actually impaired profits instead.

It is no secret that profits are the essential condition that motivates businesses to increase production, employment and capital investment. In light of this fact, it appears obvious that this prolonged profit squeeze in the 1990s critically influenced the following investment slump. After an increase by $361 billion during 1998–2000, business fixed investment fell in the following three years by about $150 billion.

However, this still leaves us with the question of what had been precipitating the profit squeeze during the boom. Answering this question requires a macro perspective, in contrast to the popular micro perspective that focuses on effects concerning the single firm. There has always been a strong inclination to assume wrongly that what benefits a single firm must essentially also benefit the entire business sector. It may even be damaging.

An obvious paradox example of this kind is wage cuts. As everybody knows, wage and salary disbursements are a major influence on a firms' profits. Accordingly, it is commonly believed that cutting wages is a sure way to improve aggregate profits. But there is a snag to this conclusion. Looking at the business sector as a whole, general wage cutting reduces business revenue as well as business expenses. Less wage expenses implicitly mean less worker income and, therefore, less personal spending on goods and services sold by businesses.

The old economists were well aware of such possible, diametric differences in economic effects between the micro and macro perspectives, calling it the fallacy of composition. This contention, by the way, applies just the same to the present American corporate fad of job outsourcing, just as it is true for corporate downsizing. To be sure, it directly bolsters the profits of the firms that practice this quirk. Looking, however, at the economy as a whole, the associated domestic job losses imply lower domestic spending and in its wake also lower domestic business revenues

in the aggregate.

Think macro, not micro. To quote the Levy Institute, the one great exception from this narrow-minded economic thinking in America, *"No firm can make its own profits. It can only win some of those generated by the economy."*

At the macro level, aggregate profits of enterprises represent the excess of sales or revenues over total current expenses. For some mysterious reason, corporate management in the United States seems obsessed with the idea that cost reductions are the safest and quickest way to raise profits. It is a catastrophic error for America. What American policymakers and economists grossly fail to see is that on the macro level, general cost cutting inexorably translates into general revenue cutting.

WEALTH EFFECTS THAT IMPOVERISH

Pondering the major causes of the U.S. profit and investment slump during the last few years starts for us with the money and credit deluge that has been swamping both the economy and its financial markets since 1997. From 1996 to 1998, overall credit growth, financial and nonfinancial, almost doubled from $1.2 trillion to $2.2 trillion.

Credit excess does not have economically determined effects. These are entirely contingent upon the use to which the borrowed money is applied. In the United States, the developing credit bubble went overwhelmingly into two channels: *first*, businesses borrowed like crazy to finance a merger and acquisition mania; and *second*, consumers went on an unprecedented borrowing and spending binge because they felt enriched by the huge capital gains accruing in the stock market.

As mentioned earlier, profits of firms in the nonfinancial sector fell during the U.S. economy's three "new paradigm" boom years, 1998–2000, by 16%. Yet stock prices escalated with growing speed, reflecting extremely loose money and unbridled euphoria about an economy producing the greatest productivity and profits miracles in history. Over less than two-and-a-half years from end-1997 to March 2000, the Nasdaq Composite index had rocketed by 243%, the S&P by 41% and the Dow Jones by 27%.

Over this period of little more than two years, the market value of personal holdings of equity and mutual funds surged from $7.7 trillion to $11.8 trillion; that is, by more than 50%. Taking the big gains in the stock market apparently as a new source of saving, consumers slashed their savings rate, measured against disposable income, to 2.6%, from 4.8% in 1997 and 7.1% in 1993.

Manifestly, the U.S. economy had turned into a "bubble economy." By definition, this term signifies an economy where sharply rising asset prices induce an accelerating borrowing and spending binge, directly propelling economic growth.

In the United States, this boost to demand and economic growth occurred overwhelmingly through the wealth effects of the stock market bubble on consumer spending. With so many Americans exposed to equities, the stock market was driving the economy as people adjusted their spending in response to the perception of rapidly growing financial wealth. But inherently, U.S. economic growth also became increasingly lopsided toward consumption, claiming a rising share of GDP.

This inherent distortion of demand growth would have worried many a central banker. Not so Mr. Greenspan, however. In his congressional testimony on Jan. 20, 1999, he hailed it as a new healthy development:

> *While discussions of consumer spending often continue to emphasize current income from labor and capital as the prime sources of funds, during the 1990s, capital gains, which reflect the valuation of expected future incomes, have taken on a more prominent role in driving our economy.*
>
> *The steep uptrend in asset values of recent years has had important effects on all areas of our economy, but perhaps most significantly on household behavior. It can be seen most clearly in the measured personal savings rate, which has declined from almost 6 percent in 1992 to effectively 0 today.*

> *Arguably, the average household does not perceive that its saving has fallen off since 1992. In fact, the net worth of the average household has increased by nearly 50% since the end of 1992, well in excess of the gains of the previous six years. Households have been accumulating resources for retirement or for a rainy day, despite very low measured savings rates.*
>
> *The resolution of this seeming dilemma illustrates the growing role of rising asset values in supporting consumption expenditures in recent years. It also illustrates the importance when interpreting our official statistics of taking account of how they deal with changes in asset values.*

Think of what Mr. Greenspan really said with this statement: I like the stock market bubble because it stimulates consumer spending. Yet most outrageous was his remark that households have in this way been *accumulating resources for retirement*.

This statement was more than doubtful even from the perspective of the individual household. All this wealth from rising stock prices is paper wealth until the capital gains are cashed in by actually selling the stocks, and that may have to happen some time in the future at much lower prices than those at which the stocks were bought. In any case, stock purchases are a gamble for retirement.

THE REALITY IS CAPITAL CONSUMPTION

From a macro perspective — in other words, from the perspective of the economy as a whole — the consumer borrowing and spending binge, fostered and facilitated by increasing house and stock prices, is inexorably at the expense of future income.

The bullish community in America sees only one single effect in this process, and that is the rising asset prices creating wealth for owners. The lack of income growth, the soaring domestic and foreign indebtedness, and the growing share of consumption in GDP are conveniently ignored. Former generations of economists had a very different name for such a process: illusory paper wealth leading to capital consumption and future impoverishment.

There are principally two ways how one generation can impoverish itself and later generations. One is to boost consumption by piling up foreign debts; and the other one is to boost consumption at the expense of investment spending. In other words, by bequeathing their children a shrinking productive capital stock. America's present generation is exercising both devices of capital consumption with abundance.

Capital formation takes place when a country produces more than it consumes. Capital consumption takes place when a country consumes more than it produces. As consumption absorbs a rising share in output, it implicitly leads to a declining share of investment and/or a rising import surplus, and that is what the old economists called a process of national impoverishment.

This negative assessment of the economic development in the United States is manifest from the macro perspective. Yet it is also true from the perspective of the individual asset owner. These wealth effects from rising asset prices are a great delusion. Any rise in prices, whether for stocks, houses or food, reduces the purchasing power of the community relative to those items. Strictly speaking, the asset owners are not getting richer. They are only spared this loss. But once they change their residence, they have to buy the new home at the higher price level.

It used to be an elementary truism in economics that savings determine the resources available for increasing productive employment through investment in tangible, productive capital stock, and that this capital stock represents the nation's economic wealth that determines its future living standards.

Over the last two decades, American policymakers and economists have invented ever new theories that justified and promoted policies with the exact opposite macro effect of boosting consumption at the expense of saving and investment. For the sake of higher share prices, these policies have also devastated corporate balance sheets and profits.

A CRITICAL LOOK AT MERGERS AND ACQUISITIONS

Earlier we pointed to the fatal role of the consumer borrowing-and-spending binge in propelling the trade deficit, which in turn has been ravaging profits. Very few people in America see this extremely damaging effect because macro analysis is completely out of fashion. Having said this, we come to another unrecognized macro profit-killer in the United States: the merger-and-acquisition mania.

In short, mergers and acquisitions are miserable, stupid economics. They immensely enrich investment banks and CEOs, but from the macro perspective, they produce national impoverishment by boosting consumption at the expense of capital investment. What makes no sense in macroeconomics cannot make sense in microeconomics.

We realize this is a bold and most shocking statement. The first thing to see about such “deal-making” is that it adds nothing, absolutely nothing, to the economy’s current and future income and revenue stream. These are purely financial transactions, occurring outside the economy and undertaken with the intent to extract big gains from playing market valuations. In essence, this boils down to financial plundering of corporations. The people working in these corporations are bought and sold like slaves.

The main motivation toward the public is longer-term profit improvements through synergy effects — that is, through cutting expenses. But as we explained with the case of wage cuts, cutting expenses is no solution in the aggregate because — from the macro perspective — lower expenses implicitly mean lower aggregate revenues.

Yet the worst macroeconomic damage of mergers and acquisitions occurs through their adverse effects on new capital investment. It is a highly reasonable assumption that firms “purchasing” rapid growth of assets and profits at exorbitant prices through heavily leveraged acquisitions will voluntarily or involuntarily curtail their alternative expansion through new capital investment.

To this extent, the merger mania effectively diminishes the growth of the productive capital stock. By fueling the consumer borrowing-and-spending binge, the soaring stock prices, on the other hand, boost consumption as a share of GDP. The net result, as earlier elucidated, is macro capital consumption and impoverishment.

Buying other firms for profitable expansion only makes sense under one condition: The purchase price must be below the acquired firm’s value at replacement costs. Actually, however, acquisitions have principally taken place at prices vastly in excess of current market prices for years, which in turn were already grossly in excess of replacement costs of underlying assets that such firms own.

You would think that this simple truth must be evident to anybody with a little common sense. Yes, but Wall Street succeeded in eliminating this bit of wisdom by postulating the convenient, apodictic dogma invented by some academic fool that shares in America’s perfectly efficient markets are always correctly priced. Ignore that the Federal Reserve is heavily distorting all asset prices to the upside by excessive monetary looseness and artificially low interest rates.

Mergers and acquisitions were sold to investors as a brilliant device to improve corporate efficiency and profits. What actually happened, measured by the official national income and product accounts (NIPA), was the most unusual experience that profits declined in a booming economy. Clearly, this represented a drastic failure of corporate governance during these years. Yet nobody bothered to investigate its causes.

Earlier we mentioned that general cost cutting is not prone to increase aggregate profits because, looking at the economy as a whole, it reduces business revenue as well as expenses. What makes mergers and acquisitions outright calamitous from the macro perspective are three features: *first*, the outrageous prices paid for acquisitions ravage balance sheets; *second*, making big and quick money gains precedence in corporate governance; and *third*, all this is essentially at the expense of new capital formation and aggregate profit creation.

Billions of dollars inflating the market value of existing businesses do not find their way into new investment. Instead, they have fuelled the consumer borrowing and spending binge at the expense of saving. For us, frankly speaking, this has always been absurd and grotesque economics. As a matter of fact, in essence this is anti-capitalistic.

THE MAJOR PROFIT-KILLERS

This brings us back to the question of why U.S. business profits plunged during the late 1990s in the face of a booming economy. Everyone knows firms make profits because their revenues exceed their expenses. But how does this excess come about? And what was hurting American corporate profits in the late 1990s?

A profits decline essentially implies a chasm between business costs and business revenues. Looking first at costs, we note the following:

BUSINESS EXPENSES, IN $BILLION

	1997	2000	2002
Wages and Salaries	3,877.6	4,829.2	4,974.6
Net Interest	522.6	649.1	696.9
Depreciations	614.5	748.6	908.8
Profits (Financial)	185.7	200.2	255.1
Profits (Nonfinancial)	504.5	413.4	334.3

Source: Survey of Current Businesses

In this table, two items stand out with unusually steep increases: interest expenses and depreciations. Both reflect drastic shifts in corporate policy. In their desperate attempt to boost profits per share, corporations went recklessly into debt at the expense of their equity. The surging depreciation charges, in turn, had their main cause in a major shift in capital investment away from long-lived to very short-lived high-tech investment.

Rocketing interest and depreciation expenses were the obvious profit-killers within the corporations. But in addition, there have been and continue to be two major profit-killers at work on the business revenue side. The one is the huge U.S. trade deficit, and the other one is the weakness in business investment.

Earlier we explained that the trade deficit acts as a big drag on U.S. business profits because it diverts domestic spending away from domestic to foreign producers. What's more, a lot of that money spent on foreign goods comes from wages and salaries paid by American producers. Having virtually quintupled annually from $107 billion in 1997 to recently more than $500 billion, the trade deficit has unquestionably played a most important role in depressing U.S. profits during the past years.

Finally, we come to the component in business expenditures that is ordinarily the largest and most important profit source in the capitalist economy: net business investment. This crucial importance for profits arises from the fact that business capital spending increases business revenues without generating an immediate expense, because such spending is capitalized.

The investing firms incur no expense until the first depreciation charge sets in. But for the firms producing and selling the capital goods, their spending is in full immediate revenue. Looking at the business sector as a whole, a change in net investments equals a corresponding change in aggregate profits.

Realizing that this approach of analyzing profits sources is completely unfamiliar to the great majority of American economists, we want to point out that the well-known Levy Institute has been rigorously practicing it since its existence. We learned it from the writings of Keynes and others. In our view, this approach is of compelling logic.

Assessing profits and their prospects, it is customary to look exclusively at sales prices as a measure of revenue. It ignores that business revenues are heavily influenced by changes in the trade balance, and above all by changes in net investment — that is, the difference between gross investment and depreciations. Both have been big negatives behind the poor American profit performance.

THE MOST IMPORTANT QUESTION OF ALL

Now, however, to the most important question of all at this juncture: Have the policies of the past brought the U.S. economy back to the road of sustainable growth with sufficient creation of employment? Apparently, the consensus economists are convinced that the growth acceleration in the second half of 2003, and above all a sharp rise in profits, have laid the foundation for this.

We have to admit that our own assessment is prejudiced by the postulate of the Austrian school that *"the thing which is needed to secure healthy economic growth is the most speedy and complete return both of demand and production to its sustainable long-term pattern, as determined by voluntary consumer saving and spending."*

Friedrich Hayek said in 1931, *"If the proportion as determined by the voluntary decisions of individuals is distorted by the creation of artificial demand, it must mean that part of the available resources is again led into the wrong direction and a definite and lasting adjustment is again postponed. And even if the absorption of the unemployed resources were to be quickened in this way, it would only mean that the seed would already be sown for new disturbances and new crises."*

We think this precisely describes what has been happening and continues to happen in the United States. The Greenspan Fed has discovered a new, amazingly easy and quick way to create higher consumer spending virtually from thin air — by way of so-called wealth creation through asset bubbles. It began with the stock market bubble, to be followed by bubbles in bonds, house prices and mortgage refinancing.

Measured by real GDP growth, it seems a successful policy. But measured by employment and income growth, it is an outright disaster. As explained earlier, the wealth effects are not for real, neither for the economy as a whole nor for the individual asset owners. The reality in the long run is only the horrendous mountain of debts that consumers, corporations and financial institutions have piled up.

Given the general euphoria about the U.S. economy and its recovery, there appears to be a general apprehension in the markets that the Federal Reserve will be forced to raise interest rates in the foreseeable future. Strikingly, the Fed is manifestly anxious to dispel any such fears — and this, in our view, is for a compelling reason. U.S. economic and financial stability have become inexorably dependent on the existence of a steep yield curve allowing and fostering unlimited carry trade in long-term bonds. Any major rise at its short or long end would shatter this artificial stability and send the economy and financial system crashing.

Considering all the imbalances impairing U.S. economic growth, we are unable to see the sustained, strong recovery. A closer look at the recent economic data confirms this skepticism. Possibly, if not probably, economic growth has already peaked. For us, the question rather is when general disappointment will gain the upper hand.

LOOMING DOLLAR CRISIS

That, of course, is sure to soothe the bond market, allowing moreover the Fed to maintain low interest rates. But it will conjure up another, even greater risk at the currency front. It will pull the rug out from under the dollar.

In our view, the U.S. trade deficit is big enough to cause a true tailspin of the dollar against all currencies. So far, two things have prevented this threatening dollar collapse: the gargantuan dollar purchases by Asian central banks and the still rather positive perception around the world of the U.S. economy. In our view, few people realize its true weakness and vulnerability.

There is widespread hope that the falling dollar will go a long way to lower the U.S. trade deficit. It takes a lot of wishful thinking to believe that. Its persistent growth has various reasons. One of them is that the gap between exports and imports has simply become too big to be reversible. Last year, exports amounted to $1,018.6 billion and imports to $1,507.9 billion. Just to prevent a further rise of the deficit, exports would have to rise 50% faster than imports.

Principally, the trade flows of a country are exposed to three major influences: *first*, relative prices and the exchange rate; *second*, relative demand conditions; and *third*, relative supply conditions.

Empirical experience suggests that exchange rate changes by themselves have very little effect on trade flows. One obvious reason is that Asian as well as European exporters readily adjust their prices to maintain their market shares.

For years, the United States has been top in the world with its domestic demand growth propelled by the loosest monetary policy in the world. For sure, lacking demand growth in the rest of the world has played a role in boosting the U.S. trade deficit. Yet what matters most for the trade balance is not U.S. growth in relation to other countries, but U.S. demand growth in relation to U.S. capacity and capital-stock growth. In essence, such a deficit indicates an equivalent excess of domestic spending over domestic output.

More precisely, the U.S. trade deficit reflects gross overspending on consumption on the demand side and a grossly unbalanced investment structure on the supply side. There was gross underinvestment in manufacturing versus gross overinvestment in retail, finance and high-tech.

CONCLUSIONS

Pondering the further development, our first assumption is that there is no intention or will on the American side to correct any of these maladjustments. Given their enormous size, it is a Herculean task, too Herculean, in fact, to be seriously addressed.

Principally, American policymakers and economists take only two economic problems seriously: high rates of inflation; and, in particular, slow growth and rising unemployment. They could not care less about the dollar. The low inflation rate is the excuse for more of the same extreme monetary looseness.

There is quite a variety of accidents waiting to happen in the markets. The most predictable and biggest risk is a dollar crisis. In addition to the gargantuan trade deficit, looming in the background are existing foreign holdings of dollar assets in the amount of $9 trillion.

As explained, the tremendous vulnerability of the U.S. bond market due to its underlying heavy leveraging prohibits any defense of the dollar through tightening. Instead, the plunging dollar will pull the rug out from under the bond and the stock markets.

The U.S. economy’s key problem is not foreign competition, but its own micro- and macroeconomic policies boosting consumption at the expense of investment and its trade balance.

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